

A Model of Chinese Capital Account Liberalisation

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Summary

In shaping the evolution of the global financial system in the decade ahead, few events will likely be more significant than capital account liberalisation in China and the internationalisation of the renminbi. With limited capital account convertibility until now, China has developed an asymmetric international balance sheet which has a long position in debt and short position in foreign direct investment and portfolio equity. But as China liberalises its capital account, its international investment positions may change significantly. This paper provides a theory-based enquiry into the contours of China's international balance sheets after the renminbi becomes convertible under the capital account.

We construct a two-country general equilibrium model with trading in equities and bonds and calibrate the model with US and Chinese data. We interpret Chinese capital account liberalisation as a removal of restrictions that prohibit agents from trading Chinese bonds and US equities. We explore how international risk-sharing can be achieved through portfolio diversification in each of these asset market configurations. We also look at how these holdings would change as China gradually rebalances its production with a higher share of labour income, and as the productivity gap between China and the US narrows.

We find the following qualitative results from our real, baseline model. First, both US and Chinese residents would have incentives to increase their holdings in each other's equities. Portfolio equity and FDI flows, both into and out of China, would increase significantly. Second, China as a whole would reverse its position in US bond holdings, from a long position to a short position. Third, non-Chinese residents will have incentives to issue debt in renminbi. We interpret this observation as the co-existence of the US dollar and the renminbi as major international currencies.

In the extended model with nominal rigidities and shocks, we obtain more reasonable quantitative predictions of the changes in international investment positions. We find an increase in Chinese holdings of foreign equities and foreign holdings of Chinese equities by 35% and 28% of Chinese output respectively, from the steady state before liberalisation to the steady state after liberalisation. In terms of bonds, our result suggests that Chinese holdings of foreign bonds will move from 38% of output before liberalisation to -48% of output after liberalisation, and that non-residents will issue renminbi-denominated bonds of around 80% of Chinese output in the steady state after liberalisation. Finally, we show that as China grows and rebalances its economy, Chinese residents will hold a larger share of US equities, and a smaller share of US bonds, as a share of US output.